Appendix B. Lessons Learned from Other Posts and Industries

While the Postal Service's business and regulatory model is unique in some ways, due to its size and the fact that it is a labor-dependent industry, "lessons learned" can still be found in the experience of other posts and other industries.

1. Other Posts

There is no one "right" model that fits all posts. In fact, foreign posts have a variety of business and regulatory models, and the origin and evolution of these models are deeply rooted in the underlying economic, political, social, cultural, and geographical nature of each country. For example, in a number of European countries, there is a history of posts having authority over some or all of the telecommunications their own countries. The more recent action to de-link the posts from the telecom providers was one of the rationales for the liberalization movement among most of European posts. Ownership of posts varies by country, with some being partially or fully owned by the public. Regulatory models also vary among posts, from minimal to very hands-on regulation. Appendix C contains a table with detailed information on other posts and their regulators. Below is a brief discussion of some of the lessons learned from looking at the regulatory and business models of other posts.

a. Universal Service Obligation Must Be Funded

The requirement to provide universal service does not fall on the post in all countries. Sometimes, USO is the obligation of the regulator. But regardless of who is obligated to provide universal service, sufficient funding sources must exist in order for it to be fulfilled. The presence of a legal monopoly on the delivery of letters is one such mechanism to protect the funding source. As current circumstances show, however, the legal monopoly has become less meaningful as it is eroded by electronic diversion of mail. Some posts – Italy and France, for example – receive direct subsidy payments from their governments to compensate for the cost of providing universal service. In addition, as discussed below, some posts generate a large portion of their revenue from services other than mail.

b. Many Posts Generate Substantial Revenue from Non-Mail Services

Many posts leverage their assets and generate revenue by offering products beyond mail services. By diversifying into adjacent lines of business, the foreign posts are mitigating the risk of significant declines in mail volumes. There are numerous examples. One is Japan Post, which is a leading provider of financial services, including savings accounts and insurance, to households. Additionally, Japan Post offers logistics services.

Another example is Germany's Deutsche Post DHL, which offers an array of logistics, financial, and other nonpostal services. In 2006, Deutsche Post DHL (then called Deutsche Post World Net) derived 76 percent of its revenue from the sale of products and services outside of mail. In addition, the Netherlands postal operator TNT also provides logistics services. In 2006, TNT derived 60 percent of its revenue from the sale of products and services outside of mail. Other posts offer customers products and services outside of the financial services and logistics arenas. France's La Poste and Australia Post are allowed to provide sales of telephony products, including mobile phone recharge cards. Australia Post has also recently expanded into the general insurance sector, "as part of a financial services strategy that could ultimately see the nation's postal service with a foothold in banking."[1]

c. Liberalization Does Not Always Benefit All Customers

The UK serves as a revealing case study of how well-intended liberalization rationales have resulted in a situation with significant unintended consequences. While European Union studies show that liberalization in the EU has been marked by increased choice for bulk business customers by adding downstream access (worksharing), one study has questioned the effects of liberalization in the UK from the perspective of individual consumers and small business. In 2008, an independent review panel (commissioned by the UK's Secretary of State for Business, Enterprise, and Regulatory Reform) on the UK postal services sector addressed the future of Royal Mail and, specifically, the role of regulation.

In its report, this independent review panel reported that liberalization has produced few of its expected benefits while significantly increasing costs for Royal Mail and consumers.[2] Almost all new market entrants have focused on high-volume business customers and the upstream market, leaving Royal Mail with 99 percent of the more costly market in end-to-end delivery of addressed letters.[3] Large businesses have indeed benefited from greater choice, more quality assurance, and prices that are estimated to be 5 percent lower than without competition. Nevertheless, large businesses are dissatisfied with the level of confusion about Royal Mail's flexibility under the regulatory framework, particularly in terms of negotiating arrangements that meet their needs.

The study finds that small- to medium-sized businesses and individual customers perceive no significant benefit from liberalization. On one hand, these low-volume customers are unable to attract Royal Mail's competitors. On the other hand, the need to compete for

[1] *The Australian*, "Australia Post pushes into insurance," September 2, 2009.
[2] See generally Hooper et al., "The Challenges and Opportunities Facing UK Postal Services: An Initial Response to Evidence" (2008).
[3] *Ibid.* "Last mile" delivery service accounts for 60 percent of Royal Mail's costs.

more profitable customer segments has forced Royal Mail to reduce service and increase first- and second-class stamp prices, creating pricing that customers find confusing.[4] These cost-saving measures are necessitated by Royal Mail's inability to raise external capital, its labor and pension costs, and the need to submit adjustments in its product portfolio and prices to preemptive regulation.

These factors led the independent panel and Postcomm, the UK's postal regulator, to estimate that Royal Mail's letter business will continue to make a loss, reaching £400m in annual negative cash flow by 2012-13.[5] Most recently, the UK has been plagued with localized postal strikes, stemming from disagreements about modernization with unionized workforce. In the face of the deleterious effects of liberalization, small- to medium-sized businesses and individual consumers are near-unanimous in their support for the existing USO. Based on the panel's review, it is clear that the only benefits of UK liberalization have occurred in the upstream sector (which is already liberalized in the U.S.), and that liberalization has otherwise harmed Royal Mail, individual mail users, and small- and medium-sized businesses.

d. Heavy-Handed Regulation Can Be Ineffective

Another lesson learned from the international postal experience is that heavy-handed regulation does not work. One notable example is the UK, where Royal Mail is regulated by Postcomm. In its 2008 report, an independent review panel recommended significant changes to the regulatory structure. Perhaps the most significant recommendation with regard to the regulatory structure was that Ofcom, which regulates the broader UK communications sector, should replace Postcomm, which regulates only the postal industry. The panel explained the rationale for this recommendation:

> "…the explosion in digital media has changed the demand profile for postal services, and has prompted an overall decline in the volume of letters. Post is increasingly part of a much wider communications sector, in competition with broadcasters, internet providers, and telephone companies. Indeed, e-substitution had a much greater impact on Royal Mail's performance in 2007-8 (reducing operating profit by £500 million) compared with postal competition (a reduction of £100 million). Despite increasing competition from digital media, it is highly likely that Royal Mail retains market power in the provision of some postal products. Focusing regulation on the areas where Royal

[4] Ibid. Customers find the perceived reductions in service more visible than Royal Mail's achievements in quality of service.

[5] According to a survey by the Federation of Small Businesses, 83 percent of small businesses and 92 percent of medium-sized businesses believe that Royal Mail's first-class mail service offers good value for money as it stands. 86 percent of individual consumers agree (90 percent in rural areas), even though first- and second-class stamp prices have risen 7 and 14 percent, respectively, since 2005. Although few consumers (13 percent) are familiar with the concept of universal service, most of them defend the USO, particularly 6-day-a-week delivery, when explained. Ibid.

Mail's market power lies will require a regulator which can set post within this broader communications context."[6]

2. Lessons Learned from Other Industries

In addition to learning from the experience of foreign posts, it is important to look at other industries in the United States for lessons learned. During the preparation of this report, the Postal Service looked at several nonpostal industries. While no other industry has the exact characteristics of mailing industry, and no one company has the exact characteristics of the Postal Service, there are several compelling lessons to consider when choosing a future business model for the Postal Service.

a. Legacy Costs and Labor Costs Must Be Managed, Especially in Times of Declining Volume

As mentioned earlier in this report, part of the Postal Service's financial challenge is that it has costs that it cannot easily control, including labor costs and "legacy costs", such as the cost of maintaining its network and the cost of retiree benefits. Other industries have been severely hampered by these types of costs as well, especially in times of declining volume.

The first example is the American auto industry and its recent financial crisis, which sent the industry reeling. Auto manufacturers in the U.S. have faced high labor costs – including salaries, benefits, and pensions -- especially relative to the labor costs of their non-unionized competitors overseas. In addition to paying high labor costs for their current workforces, the Big Three automakers have incurred a mountain of legacy costs for their retirees. These legacy costs are due to a large number of retirees, and the sizable benefits coverage offered for each retiree. The auto industry's crisis resulted in government bail-outs for Chrysler and General Motors, and in the provision of a substantial line of credit to Ford. In addition to the infusion of billions of dollars in federal funds, the restructuring of the auto industry has included significant concessions by labor unions, management, suppliers, dealers, and shareholders and lenders.

Another example of an industry that has faced burdensome legacy and labor costs is the freight railroad industry. Prior to the passage of the Staggers Act of 1980, railroads found it difficult to obtain approval from the Interstate Commerce Commission to close unprofitable track and services.[7] The industry was plagued with high labor costs and lack of capital investments, and, to make matters worse, railroads began facing competition from automobiles, airlines, and the trucking industry. The railroads' share of intercity freight movements fell from 75 percent in

[6] Hooper et al., "Modernise or Decline: Policies to Maintain the Universal Postal Service in the United Kingdom"; p. 88 (2008)
[7] Dr. Brian Slack, Rail Regulation in the United States. The Geography of Transport Systems.

1920, to 35 percent by 1975.[8] Railroads began to go bankrupt; by 1960 one third of the rail industry was bankrupt or close to failure.[9] Subsequently, the impact of the Staggers Act was significant. It streamlined the procedures to sell rail lines,[10] and railroads began divesting their unprofitable passenger business to focus on bulk freight.[11] Railroads also began to abandon unprofitable, low density tracks.[12] Mergers and changes in union rules allowed staff reduction, which in turn led to a decline in operating costs.[13] The Staggers Act's impact on labor was to reduce jobs, but not lower wages.[14]

The lesson learned here is that in times of declining demand for products, legacy and labor costs can add to the financial burden of an industry. If the industry is not granted the flexibility to better manage its costs, as was done in the freight railroad industry, the result could be a financial crisis, as illustrated by what happened in the auto industry.

b. Successful Deregulation Gives Players Freedom to Operate

The success of deregulation depends on giving the deregulated industry enough flexibility to operate in a competitive environment. The freight railroad industry is one example of such a "success."[15] While the Staggers Act of 1980 did not completely de-regulate the railroad industry, it did give the railroads significantly more freedom to make decisions, and it recognized the need for railroads to make revenue, allowing them the use of differential pricing.[16] The Staggers Act also allowed the railroads to abandon unprofitable tracks, and gave railroads the freedom to make some operational and technological improvements, such as greater use of intermodal operations, development of double stack rails cars for manufactured commodities, and improved tracking of shipments.[17] Improved cash flow allowed the railroads to invest in technology and new capital, such as stronger and better maintained tracks.[18]

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[8] Ibid.
[9] Ibid.
[10] Association of Railroads, The Impact of the Staggers Act of 1980. (August 2008)
[11] Dr. Brian Slack, Rail Regulation in the United States. The Geography of Transport Systems.
[12] Ibid.
[13] John D. Bitzan and Theodore E. Keeler, "Productivity Growth and Some of Its Determinants in the Deregulated U.S. Railroad Industry." Southern Economics Journal, vol. 70. (October 2003)
[13] Laurits R. Christensen Associates, Inc, A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition. Final Report. Prepared for the Surface Transportation Board (2008) ES-8.
[14] Clifford Winston. The Success of the Staggers Rail Act of 1980. Brookings Institution. (Sept. 2005)
[15] The GAO raised some questions about the success of the deregulation of the railroad industry, specifically questioning if the railroads were charging unfairly high rates to captive shippers. Christensen Associates found that the increase is rates has been driven by an increase in costs and is not due to abusing market power.[15]
[16] Association of Railroads, The Impact of the Staggers Act of 1980. (August 2008)
[17] Clifford Winston. The Success of the Staggers Rail Act of 1980. Brookings Institution. (Sept. 2005)
[18] Ibid.

Productivity increased, and so did safety.[19] Deregulation was also good for shippers, because it led to lower rates. While some decline in rates has been due to a greater proportion of lower-priced bulk traffic, deregulation itself also played a role. It led to faster service, due in part to mergers offering more end-to-end service (meaning less time spent switching railroads). Regarding financial solvency, railroads have been close to being revenue-adequate, but most, unfortunately, still fall short. [20]

Deregulation, however, has not always given an industry enough flexibility. The airline industry, which made substantial gains as a result of deregulation, continues to be plagued by fundamental problems. Some of the problems are transitional, reflecting the massive adjustments required by the end of a half century of strict regulation. The regulated airlines received returns on capital that were supposed to be reasonable, but which factored in high costs that would have not existed in a competitive market. For example, the airlines' unionized workforce – established and strengthened under regulation and held in place by the Railway Labor Act – gained generous salaries and work rules compared with what would reasonably be expected in a competitive market. Problems remain today, especially with the legacy airlines.[21]

c. Need for Retail Outlets Changes with Time

The Postal Service recently announced plans to study the potential closing of some of its retail stations and branches. While a large public outcry greeted this announcement, the Postal Service is not alone in its desire to close some of its retail outlets. It is not unusual for other industries to close retail outlets in response to changes in the market and economic conditions. For example, Bank of America recently announced its plans to reduce the size of its branch network by 10 percent in response to the changing habits of Bank of America customers, who increasingly go online for their banking needs and transactions.[22] In addition, Citigroup has said it may sell or close some of its 1000 retail outlets.[23] The banking industry has determined that there is a need for some physical outlets, because they supply a competitive advantage and bring in new customers.[24] In another example of responding to market and economic changes, Starbucks closed 600 stores in the United States in 2008 due to lagging sales, and is working to

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[19] Association of Railroads, The Impact of the Staggers Act of 1980. (August 2008)
[20] Laurits R. Christensen Associates, Inc, A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition. Final Report. Prepared for the Surface Transportation Board (2008) ES-20
[21] The Concise Encyclopedia of Economics, Fred L. Smith Jr. and Braden Cox, www.econlib.org/library/Enc/AirlineDeregulation.html
[22] http://www.dailyfinance.com/2009/07/28/bank-of-america-to-close-10-percent-of-branches/
[23] http://www.bloomberg.com/apps/news?pid=20601087&sid=aeVN.BDkfs98
[24] Matthias M. Bekier, Dorlisa K. Flur, and Seelan J. Singhman. A Future for Bricks and Mortar. The McKinsey Quarterly 2000 Number 3.

close an additional 200 U.S. stores.[25] The objective of these companies clearly isn't to eliminate all retail outlets, but instead to optimize its presence with lower cost alternatives.

d. Large Costly Networks and Cyclical Demand Are Difficult to Manage

The Postal Service's large network incurs costs that cannot easily be adjusted to sudden changes in volume. The airline industry has had similar problems. Since the airlines were deregulated, earnings have been volatile. Despite some periods of growth and increased earnings, airlines have suffered such overall financial distress that many have filed for bankruptcy, and the industry as a whole has failed to earn sufficient returns to cover capital costs. Over the past 30 years, more than 150 airlines have sought bankruptcy protection, or disappeared entirely.[26] Some academics and industry analysts view the airline industry as inherently unstable because of key demand and cost characteristics. The demand for air travel is highly cyclical in relation to the state of the economy, but the industry's cost characteristics can make it difficult for carriers to quickly align the supply of air service to shifting demand.[27] In response to market demand, airlines have reduced the number of flights and the size of planes where possible. The airline industry example provides parallels that can be applied to a discussion of the future business model of the Postal Service and possible liberalization. The demand for postal products and services, like the demand for air travel, is highly cyclical in relation to the state of the economy; both industries sustain a high level of costs for fixed networks that cannot be quickly adjusted when demand declines. This can lead to insolvency, as demonstrated by the airline industry example.

e. Large Public Service Industries Often Need Government Subsidies

Even when industries are "deregulated," the government has occasionally stepped in to subsidize them to ensure the public does not suffer from lack of service. In the U.S. telecommunications industry, key policy developments have incorporated the following major objectives: promoting universal access to telecommunications services; encouraging new technologies through a framework that allows innovation; reducing regulatory burdens to spur investment in broadband infrastructure; encouraging competition to provide consumers with lower prices and choice among providers; providing the necessary communications services for public safety and emergency response, and managing scarce resources by allocating wireless

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[25] Starbucks to Close 300 Stores. Huffington Post. January 28, 2009.
[26] Did Ending Regulation Help Fliers?, NY Times, April 17, 2008.
http://www.huffingtonpost.com/2009/01/28/starbucks-to-close-300-mo_n_161979.html
[27] GAO Report - Airline Industry Contraction Due to Volatile Fuel Prices and Falling Demand Affects Airports, Passengers, and Federal Government Revenues, April 2009.

spectrum among competing users.[28] To ensure that these objectives can be met, Congress subsidizes the development of rural telephone service (about $7 billion); it also subsidizes the Internet (in the amount of about $4 billion, with an additional $7 billion planned under the Recovery Act).

As noted previously, the freight rail industry has undergone a remarkable transformation. Prior to 1980, it was heavily regulated by the government in order to maintain open access.[29] Even after deregulation, however, federal and state governments have provided funding for freight rail projects in order to ensure capacity. For example, in 2005 Congress provided $100 million to fund Chicago area rail improvements.[30]

Since the creation of Fannie Mae and Freddie Mac as Government-sponsored Enterprises (GSEs), there has been ongoing debate as to the role of GSEs in the marketplace, even as the two enterprises played a significant role in helping the U.S. achieve the highest levels of home ownership in the world. The debate about the role of GSEs became more prominent, though, during the housing market collapse and subprime mortgage crisis of the last two years, which resulted in their financial demise. The federal government received both institutions under conservatorship by September 2008

f. Not Every Market Benefits from Open Competition

Industries with high costs of entry, flexible supply, and inelastic demand, and corporations that provide necessities to households and industry represent markets that do not benefit from open competition, and may need regulation in order to avoid destructive externalities and unfair pricing. Over the last decade, a number of states deregulated their electric utility markets with the goal of increasing competition, reducing prices, and providing greater consumer choice of suppliers. However, in a number of states, including California and Montana, the deregulation experience has been one of volatile electricity prices and decreased reliability in service, as evidenced by the rolling brownouts in California. A critical lesson provided by the deregulation of the electric utility markets in California and Montana is that once the market is deregulated, it is very difficult to go back and reregulate in order to correct the "mistake." Such reregulation is often called for by people who initially supported deregulation, but who call for a return to regulation when they are personally affected by increased rates. Unfortunately, the cost of reversing deregulation can be prohibitive.

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[28] Ibid. 1-23

[29] Dr. Brian Slack, Rail Regulation in the United States. The Geography of Transport Systems

[30] Freight Railroads. Industry Heath Has Improved , but Concerns about Competition and Capacity Should be Addressed. GAO-07-94. (October 2006) 5.